

January 31, 1979

LETTER 749

Jan. 19, DJIA 837.49; PTI 901; A-D ratio -19.94

Jan. 26, DJIA 859.75; PTI 921; A-D ratio -19.30

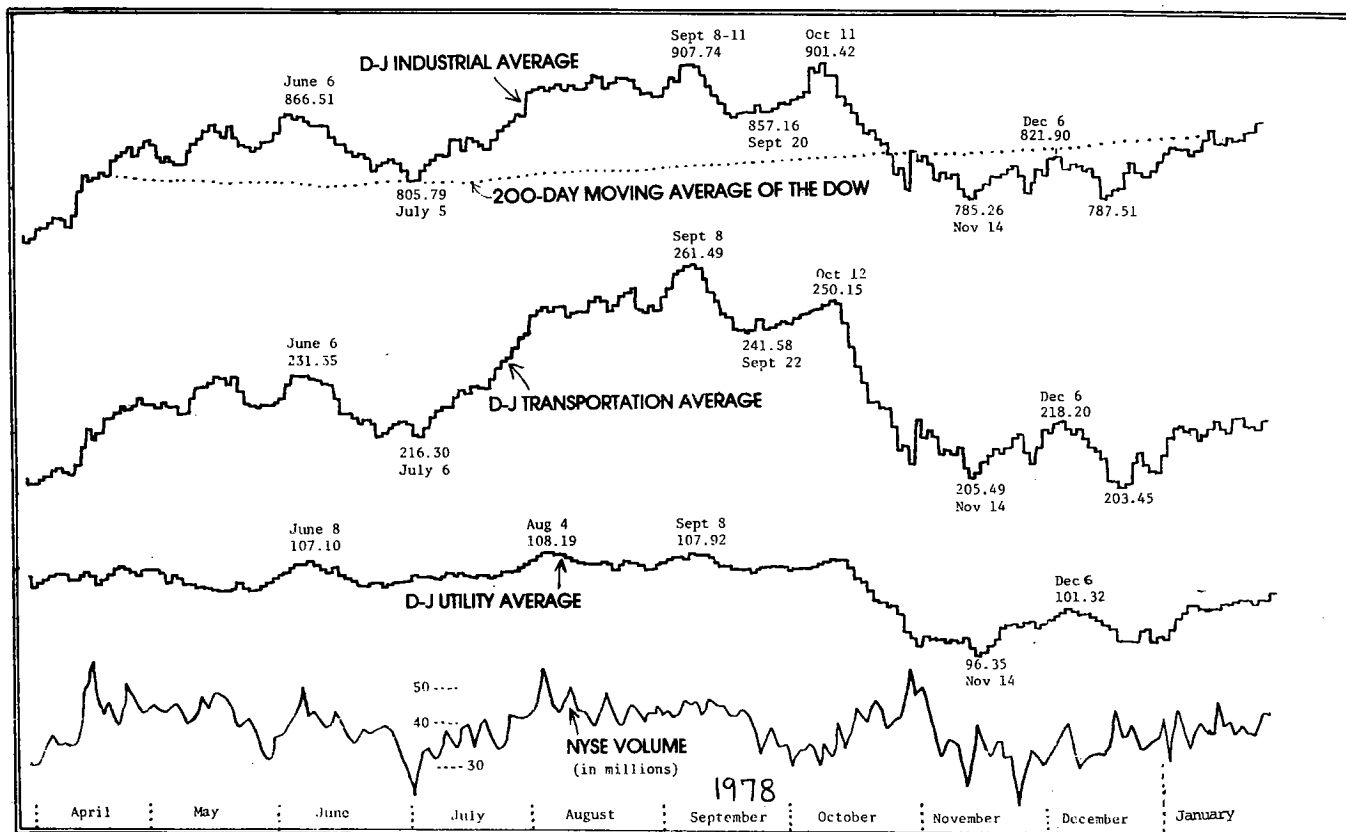
WHAT GOES?: Subscriptions have been arriving here in record numbers, and this pleasant but rather surprising phenomenon has caused me to stop, look and ponder, "What goes on?" I ask myself. After all, I haven't called any great and dramatic buy spots in the stock market. I haven't been excited about commodities. I said (after the 243 top had passed) that I was scaling back on gold. I did say in the last Letter that bonds might be moving into an interesting "buy zone." I have had my subscribers sitting in 91-day Treasury bills, which is hardly an exciting situation (but we haven't lost any money on them). I have been saying that the dollar was fated to be stronger, and it has been stronger. I said that the Swiss franc, the mark and the yen would turn weaker, and they indeed have. But still—why all the expanded interest in these reports?

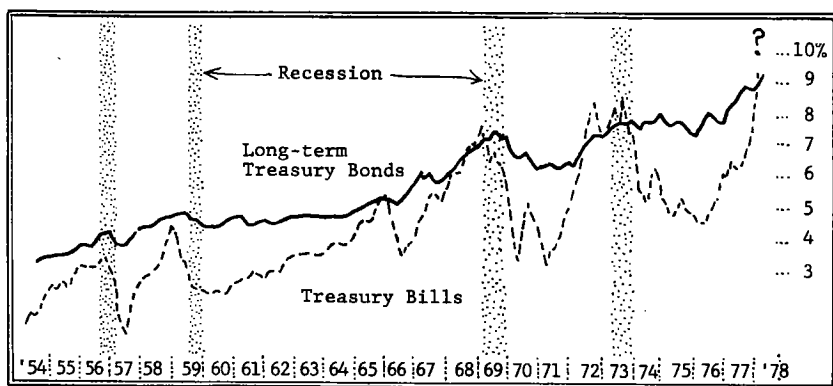
In all truth, the only thing I can think of is that my subscribers haven't been taking losses all over the lot—and I suspect that's just what has been happening to most investors everywhere (i.e., a build up of losses). As I see it, the facts run something like this: (1) When interest rates move into the double-digit zone (where they are now), it becomes extremely hard to make money in anything but short-term debt obligations. (2) With both debt and inflation in high gear, markets of all kinds have become very *volatile* and *unstable*. That kind of environment tends to produce losses for investors. (3) To top it off, the US Government is pretending to wage a great fight against inflation, but no one (least of all this writer) is convinced that they are actually doing it (the talk is great; but the action is depressing). Neverthe-

less, (4) I feel reasonably certain that if we exercise patience we are going to get some profitable opportunities, but most people lack patience and maybe they're using me as a sort of "patience-pusher" (could this be a branch of Weight-Watchers?).

I've noted that those who expect least from the markets often do best with them. And just as there is a time to sow and a time to reap and a time to rest, so there are times to be buying the markets, times to be selling the markets and a time to be out and on the sidelines. My feeling is that this is the time to be on the sidelines watching "someone else" reap the goodies. And while we're waiting, I've suggested accepting a 9.5% return from the US Treasury via their 91-day T-bills. While this isn't as satisfactory (or as much fun) as riding Bally up and down, it's easier on my nerves. Besides, it represents a policy, rather than a crapshoot. I can shoot-crap with maybe 10% of my capital, but certainly not with 90%. So if I were to buy Bally, I would only buy a few hundred shares or so, and I'm not sure the sweat would be worth the reward.

A lady subscriber recently sent me a letter that perhaps sums up the problem better than anything else I've read: "*The long-term situation seems so variable and fraught with uncertainties that I really don't believe there is a 'long-term investment posture' any more. And as far as the shorter term, if I take a loss I do so with hard, after-tax dollars. But if I make a profit, I find that Uncle Sam is my partner. So the effort is hardly worth the risk when I consider what I can actually keep after taxes.*"





HIGH FEVER: This is the chart that perhaps more than any other bothers me. What we see here is three instances of short-term interest rates (as exemplified by Treasury bill yields) **pushing above** long-term rates. Since the turn of the century, this phenomenon has only occurred six times (although there were some near misses such as 1956-57 and 1959). Each time this so-called "inversion of interest rates" occurred, it was (1) a sign of an oncoming liquidity squeeze, (2) a warning of a coming major decline in the stock market, (3) a warning of a coming business recession or depression.

In the past these inverted interest yields lasted from 13 months to 26 months. The average inversion period was 18 months. During these inversion periods stocks dropped anywhere from 25% to 89%. So far the inversion (which began in September, 1978) has lasted only 5 months. Stocks have not yet begun to decline nor has the economy started to contract.

The first period of inverted yields occurred in 1919 to 1921. This period saw the Dow crash from 119 to 64 accompanied by a severe drop in commodity prices and business. The next period was 1928-29, and this period needs no description. The third period was 1965-66, the period which saw the peak of the bull market of 1949-66. The Dow dropped from 996 to 744 in 1966. The last era of inverted interest rates was 1968 to 1970. This period saw a collapse in the whole speculative segment of the stock market while at the same time the Dow dropped from a high of 985 to a low of 635.

The sixth period of inversion is now upon us, and it has occurred with the highest crossing of interest rates in the history of the inversion pattern. Five months have now elapsed, and it is clear that the Government has been using all of its manipulative powers in an attempt to hold back both the level of interest rates and the effects of those interest rates. But in my mind, the Government's efforts will not only fail, but they will make the ultimate expression of the "interest rate sickness" more lasting and more severe than they would normally have been.

It is this chart, then, that bothers me more than almost anything else. It causes me to be extremely cautious here, and to set my eyes on the longer term. Any "plays" and speculative positions taken here (in bonds, stocks, commodities or anything else) should be assumed with the implications of the inverted yield cycle firmly in mind.

Personally (and I have no secrets) this writer prefers to stay in short-term Treasury bills. My bet is that before this year is out, despite any clever and perhaps sophisticated trading that you may be tempted to do, the holder of T-bills will probably show superior results. For if the record of the past has any validity, a period of inverted yields is a period of financial sickness, a period in which the money markets are saying "illiquidity." During such periods I would rather be a short-term lender (i.e., a holder of T-bills) than a borrower or an owner.

Yes, dear lady, this is the problem all of us face. But right now we at least have two things in our favor: (1) the high level of interest rates, and (2) the power of compounding. So let's go with the flow, buy those T-bills, sit with 10% gold (in case all else fails) and collect our interest. We may not keep up with inflation (which I suspect is nearer 12% today than 9%) but we won't sustain any huge losses. And remember the old Chinese proverb, "all comes to he who waits."

THE MARKET: From the November 14 lows, the Averages pushed up to peaks on December 6. Following a mild decline, the Averages rallied again. Since then the Industrials have clearly bettered their December 6 peak of 821.90, as have the Utilities. But the Transports are having trouble staying above their own December peak of 218.20.

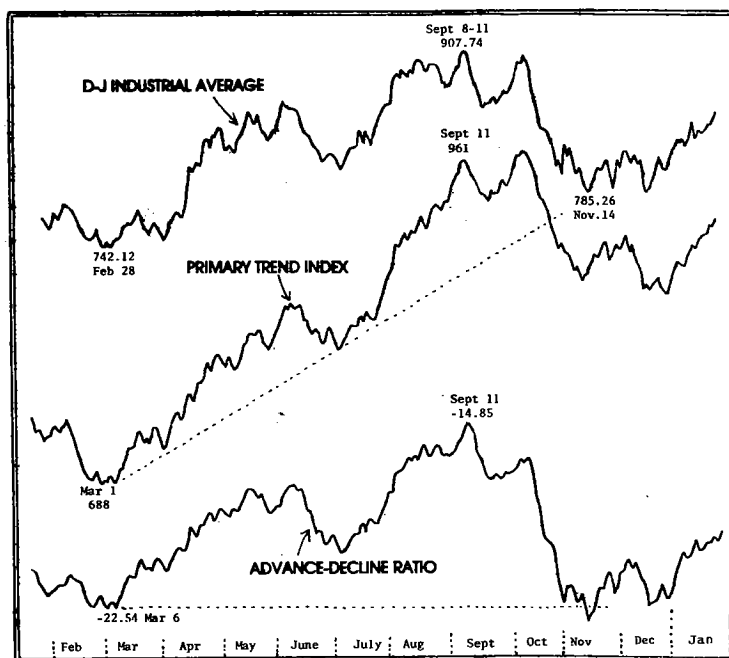
Meanwhile, excitement has been mounting, intensified by three major stock splits, IBM, DuPont and most recently Mobil. Amid the mounting volume and rise in speculative sentiment I note that new daily highs have been rather lackluster, in the 30-40 range, and far below previous peaks. Lack of pessimism is also seen in the low level of odd-lot shorts (515 shorts on January 20, 750 shorts on Jan. 21, 527 shorts on Jan. 23—all minute figures).

From a longer term point of view, the Dow is seen to be again rushing up within its trading range of 900 plus on the upside and 750 on the downside. Considering the fact that my data is now turning somewhat over-bought and considering that we are moving further and further towards the period where a major bottom should appear (or at least is overdue), I don't see the great attraction in owning stocks here.

Turning to the chart (page 3) of the Dow, the Primary Trend Index and the A-D ratio, we can say that all three indicators are in gear on the upside. However the A-D ratio is lagging and if the Dow were to push up and better its 907.74 peak of September 8, the A-D would almost surely fail to confirm. At any rate, the phenomenon which is most evident at this time is "churning" in the market. This is seen when a greater and greater amount of volume does less and less on the upward movement of prices.

THE BIG PICTURE: Over the past couple of years I've given speeches in a lot of different places—from New Orleans to Bermuda, from San Francisco to New York. All of this has given me a good deal of contact with investors, both amateur and professional. And I'd say that the one area which is most difficult for investors, the one that they find most difficult to comprehend—is *money and interest rates and debt*.

In every speech of the past year I've emphasized the point that this nation is marching down the primrose path of bankruptcy via unending deficit spending. I've emphasized the power of compound



interest rates and the fortune-building power of investing a given amount of money every year at high rates of return. I've also talked about the disastrous consequences of rising debt plus increasingly higher rates of interest to carry that debt—which is the process of compounding *in reverse*.

Please, get this firmly in mind. At 6% compounded money doubles in 12 years. At 7% money doubles in less than 11 years. At 8% money doubles in less than 10 years. At 9% money doubles in less than 9 years. At 10% money doubles in less than 8 years. At 11% money doubles in less than 7 years. And at 12% money doubles in less than 6 years.

The total US Federal debt by the end of this year will be about \$800 billion, a new record. The average maturity of the Federal debt is now under 4 years. Three weeks ago the US Treasury paid a record 10% for newly issued two-year notes. If the pressure for money continues, then the cost of servicing the US Federal debt is going to sky-rocket. This year the cost of servicing the debt will be around \$50 billion. But consider this—at the new 10% rate the cost of servicing \$800 billion of debt will jump to \$80 billion. My projections suggest that this \$80 billion cost will be hit during 1981, even assuming no more deficits. But the deficits will continue!

For instance (and this is a shocker), Messrs. Griggs and Santow of J. Henry Schroder estimate that the 1978-79 Federal budget will be approximately \$52 billion, or about the same as this year's deficit. But they also note that "our preliminary look at fiscal 1979-80 leads us to believe that even in the absence of a recession between now and mid-1980, it will take an heroic effort in limiting spending to keep the deficit from rising above this year's level." I might add that these two men are considered among the top experts on the Federal spending and deficit picture, and they do not see any reduction in Federal deficits anywhere ahead (this despite pious Administration predictions).

My own feeling is that the Administration simply *does not understand the implications of servicing rising deficits at increasing rates of interest*. For instance, the cost of servicing the Federal debt could easily jump \$30 billion between now and 1981.

Add a possible recession (with lowered tax receipts to the Government) and rising federal expenses and you have the formula for chaos in the money markets, new high levels of interest rates, a collapse in the stock market and an economic depression.

In the 1929 to 1932 period of the great crash, many investors were wiped out because they did not comprehend the scope and depth of the collapse. Following the '29 crash when the Dow dropped from 381 to 198 in a matter of weeks, many people were convinced that the worst had been seen. The Dow recovered to 294 in April, 1930, giving investors new hope. By the end of 1930 the Dow had sunk to 160. By the end of 1931 the Dow was down to 80. And then, incredibly, by July, 1932 the Dow collapsed to 41. It was the sheer size of the decline that broke many people. They could not believe the size of the disaster they were living through.

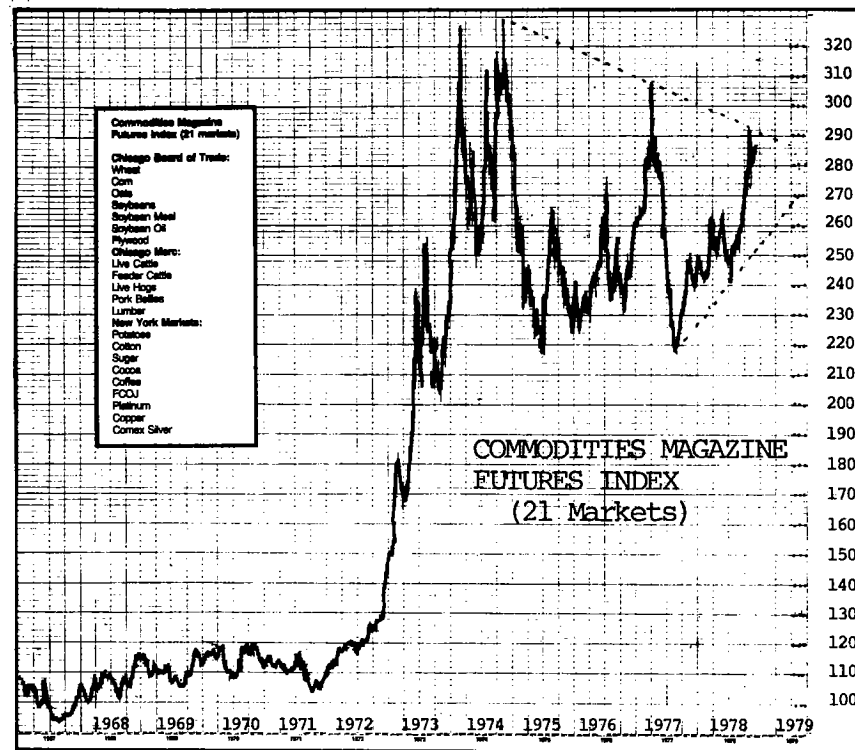
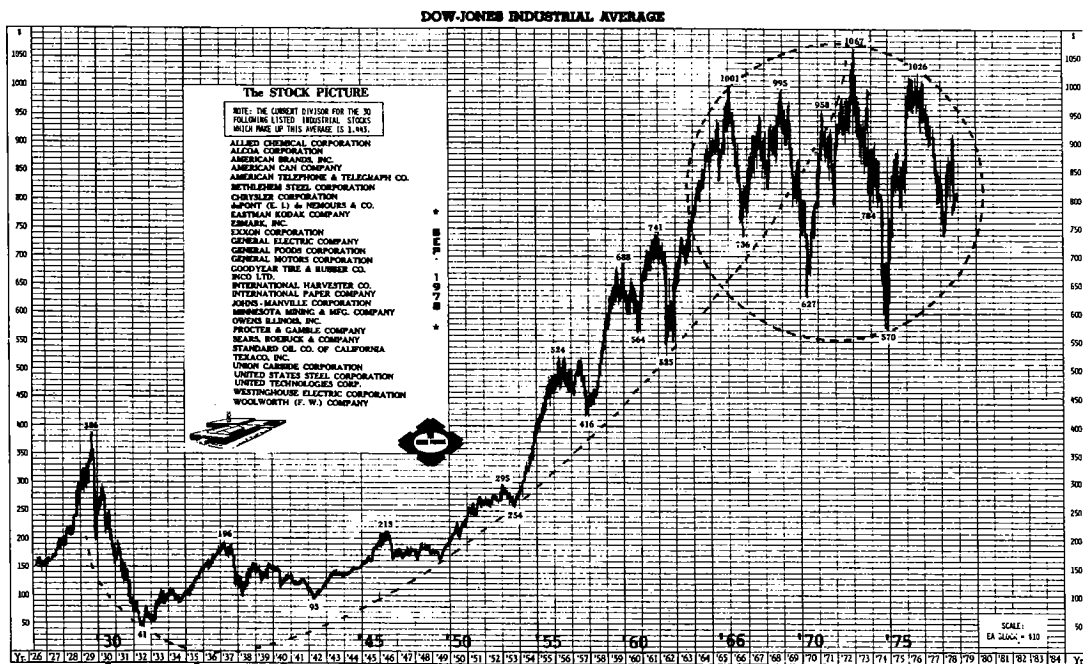
I wonder, as I add up all the debt statistics including the size of the Federal debt, the corporate debt, the individual debt, the state and city debt, if the fooler this time is not going to be **the height to which interest rates will ultimately climb**, before the worst is finally discounted. For just as the collapse in stock prices during 1929-32 drove many investors to the wall and destroyed many corporations and institutions, I feel that the coming liquidity crisis will play havoc with this generation of investors. Remember, the debt build-up we are now witnessing has been four decades in the making. It is possible that the next one or two generations will be caught in the web of unwinding the debt and liquidating the unbelievable mountain of borrowing that has fueled the so-called "prosperity" of today.

In recent Letters I have included charts of some of the major "price items" such as stocks (monthly Dow), bonds, commodities, gold. In almost every instance we see massive "congestion formations" or huge trading ranges, in some instances ranges lasting for years (such as that seen on the page 4 Horsey chart). Here we see the Dow plotted from 1926 to date. I have drawn a rising acceleration curve under the Dow, a line which exhibits an increasing rate of growth from 1938 to 1969. In 1969 the Dow broke below the growth curve, and it was seen that an enormous circle had formed. It is this circle that has contained the Dow for the past 15 years!

What I think we are seeing in the Dow and in other market items is the reflection of two mighty forces that are now meeting head on. One force is the force of inflation (inflationary bank credit). Opposed to this is the deflationary force of debt (debt which must be serviced at all costs). People today seem to understand the meaning of inflation. For years they have been watching our Government inflate the money supply, and they are finally beginning to understand what this portends. During the next few years I firmly believe that people are going to understand the meaning of debt and the deflationary force that the oceans of debt are going to exert on the economy and on their lives.

What people do not seem to understand is that the debt **remains to be paid off or serviced**, regardless of whether prices move up or down and regardless of whether the economy is rosy or black. But in the event of a downturn in the economy from current levels, it is my contention that the existing debt will exert a highly deflationary force on the economy. The coming deflation will stem from the astronomical **BUILT-IN COSTS** of servicing the debt.

This then, is the specter that I believe is exerting a **RESTRAINING** pressure on all markets at this time. It's almost as if the stock markets and the commodity markets were



saying, "Look, we'd like to react to inflation alone and just rocket off on the upside. But we're frightened of this interest-rate thing, and we don't want to get caught way up in the blue by perhaps another jump in the discount rate and another upside push in rates. So we'll just rally a bit more, then decline and test the lows, and then put on another rally."

If you think the stock market has a problem, don't think the commodity markets have it any easier. Study the page 4 chart of the new CMI (Commodity Magazine) Index of 21 commodities. Here we see the same story—wild swings back and forth with no real resolution of the inflation-deflation problem. Could any chart represent a greater puzzle to long-term traders than this commodity chart? I doubt it.

Question: Russell, I hear what you're saying about debt and interest rates. But in the last Letter you presented us with a chart of Treasury bonds, and you stated that these bonds might be nearing a bottom and an advantageous "buy spot." Great, but how does that jibe with your warnings about debt and interest rates?

Answer: The missing ingredient in the puzzle is *timing*. On January 25 the T-bonds gave a first buy signal as outlined in the last Letter. This signal is technical in nature, based on my analysis and reading of the charts. It looks as if my reading of the money markets may have been "on the button." BUT I cannot know how big a rally is in store for the money markets. Personally, I believe this is a

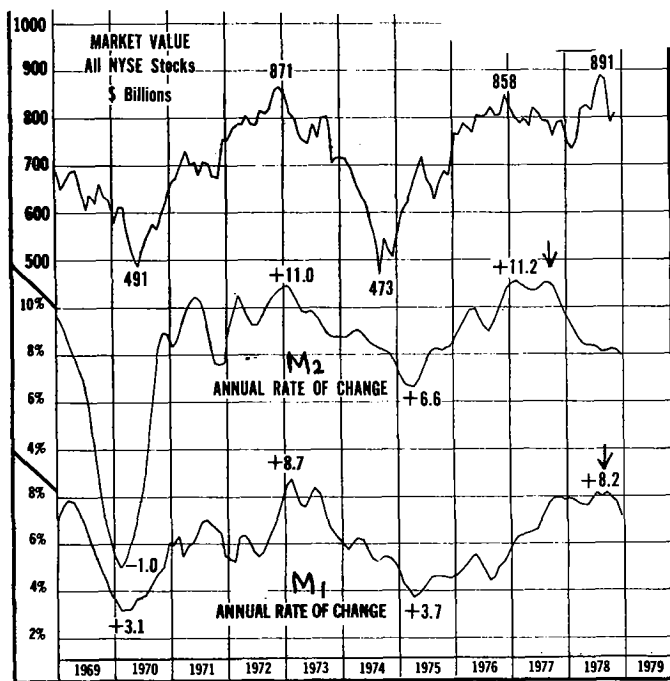
temporary rally, technical and corrective in nature. After all, the money instruments have been smashed over the past few years, with the longer term T-bonds providing record yields. Thus, from a risk/reward standpoint I thought the Treasury 8's of 1996-01 were a good speculation, and buyers could pick them up within a point of a major low (with the stipulation that if we were wrong, the bonds could be sold at but little loss).

Aside from the fact that a good (upward) correction is overdue in bonds, one thing that could militate towards lower bond yields (and higher prices) is the strength in the dollar, strength which may have been brought on by a declining rate of change in the growth of money in the US. A second factor is that the money supply for many overseas nations is now rather inflated. Switzerland, Germany and Japan have spent billions supporting the dollar, and this had the effect of increasing their money supplies tremendously. As a result, foreign money is now moving to three main areas in the US: (1) certificates of deposit, (2) T-bills, and (3) commodities. This inflow of foreign money could help to bring down US interest rates.

But I want to stress that a lowering of interest rates in the US is probably a TEMPORARY phenomenon.

Thus, those who bought bonds must be ready to sell them when I give the "word." This could only be a trading situation—but perhaps a very good one. Secondly, it should be remembered that a declining rate of change in the money supply will, in time, put an illiquid economy in a vice. Therefore, the first reaction of the money markets to a declining rate of change in the money supply is "wonderful!". The second reaction to a declining rate could be "ouch!". The third reaction could be "Help!"

MONEY, MONEY: As each Thursday comes around, investors and analysts throughout the nation wait breathlessly for the Fed figures which are released after the market's close. For years increasing inflation was considered bullish for the market, and stocks indeed did seem to move up with the inflation rate.



But that's not the case anymore. Today, rising inflation means a weak dollar, and a weak dollar means higher interest rates (since the Fed's chief method of "defending" the dollar is to boost interest rates).

In recent years a booming money supply has meant a booming stock market. This is obvious because rising liquidity tends to float everything upwards, including stocks. Conversely, it should be obvious that a downward path for the money supply tends to constrict prices, and although a shrinking money supply may be healthful for an overheated economy, it is not healthful for stocks.

Ironically, many investors seem to think that a decline in the rate of change in the money supply is a bullish phenomenon for stocks. Nothing could be further from the truth. In proof, I am including this chart from Bill Bretz's *Juncture Recognition* (Box 1209, Pompano Beach, FL 33061). Here we see the annual rate of change in M-1 and M-2. Note how remarkably the stock market follows the rate of change in the broader M-2 money supply. Note also that the rate of change in M-2 is now declining, having dropped from a peak rate of 11.2% to the current rate of 8.2% (although I would say that it is even lower today). In the past, this has been a bearish influence on the stock market, and I expect it will be again.

One more comment on the money supply. If loan demand keeps up at current rates, then a decline in the money supply would tend to run interest rates to even higher levels (a given demand chasing a shrinking supply of money). Or the declining rate of change in the money supply could reflect ebbing demand, and this in turn would lead to recession.

GOLD, RISK-REWARD: Unfortunately, most people do not operate with their money (assets) the way they operate in their own businesses. In business most people are reasonably effective. With their investments they are all too often emotional and financial boobs. I try hard to avoid boob status, both with my subscribers' money and with my own. So let me introduce four useful thoughts: (1) If I can get one good play in ANY INVESTMENT ITEM in any given year, I'll be doing all right. (2) If I

can catch two important moves in any two investment items, I will be way ahead of the game. (3) If I can get a high yield on my basic capital while I am waiting for a move in other items, I am more than happy. (4) the best risk-reward comes from buying an item that has been going down for many months (or preferably for many years) if one can buy that item at, near or in the lower range of the bottom.

Let's turn to gold. One consideration at this time is that there is a lot of good news OUT about gold. It's EASY to buy gold here. The OPEC oil price increase is known, the potentially disastrous Iranian situation is known, the big US budget deficits are known, the balance-of-payments deficits are known, and the dollar weakness is known (not so well known is the sharply improving BOP situation and the new strength in the dollar). So basically, what I note is that it feels "safe" to sit with gold here. But I liked the gold picture much better last year when the metal was going up without so many "good reasons"!

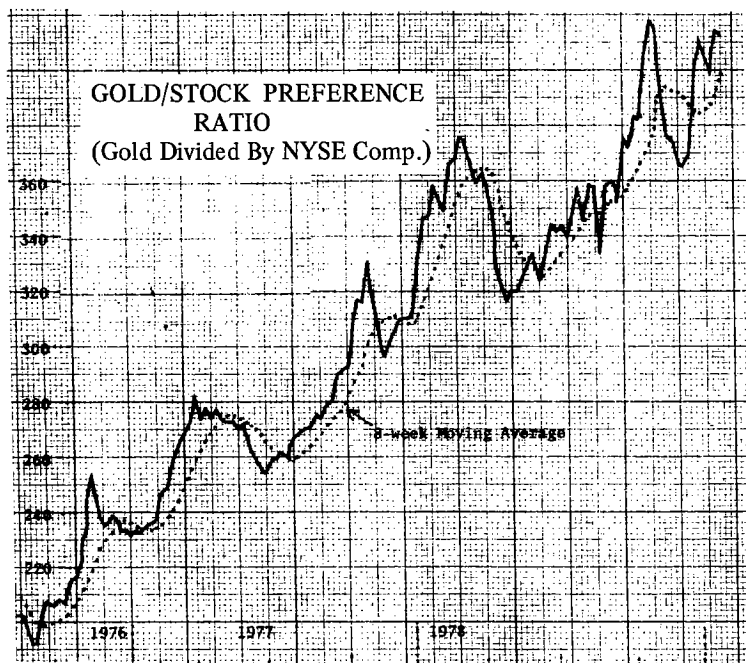
The fact is that last year we had a good play in gold. Profits for most subscribers who bought gold in the 150's, 160's or even 170's were good and in many cases excellent. I feel that gold is now in the corrective stage, and that although it is OK to hold 10% in gold (as a hedge against chaos), the risk-reward for gold holders is not particularly interesting at this time. If gold goes to new highs, say to 260, that would represent a 10% rise. I can get the same in C/D's and almost that in T-bills—with no sweat. So gold would have to go to say 300 from here for it to represent a good risk-reward for me, and I don't think it's going to do that now.

In the last Letter I suggested buying bonds if the Treasury 8's of 1996-01 hit 91. They did just that last week, and many of my subscribers took positions in all kinds and varieties of bonds. I don't know how far this bond move is going, but I know three things: (A) what's good for bonds is not good for gold, (B) bonds have collapsed over the last couple of years, and the risk-reward of owning bonds is pretty good here, and (C) an item is always most interesting when it is totally out of favor and the reason for its rise is unknown or suspect. A rising bond market here represents an interesting contrary opinion. And if the new bond rise continues, the much older gold rise will probably top out. Bonds can only rise on a strong dollar. Gold (in the face of a strong dollar) will go down.

So as I see it, the risk-reward for holding gold is not that interesting here. Gold may be very interesting three months or six months from now, but right here I'm looking at other things.

I am including my gold/stock preference chart, a chart that shows the ratio of gold divided by the price of the NYSE Composite. It is clear that from late-1976 to October, 1978 the preference (or relative strength) was in favor of gold. Following the October peak, the ratio dropped sharply, then most recently the ratio rallied back within a fraction of the October high. Thus gold hit its peak of strength against stocks last October. If the ratio breaks below the long rising trendline on the chart, it will show pronounced gold weakness against stocks. Meanwhile, stocks showed their greatest recent strength when they hit their September, 1978 peak. But that peak has not since been bettered. So one can say that since last September-October, dollars have been stronger than both gold and stocks. And bonds are now beginning to reflect this situation.

My daily chart of gold bullion and the gold stock average (GSA) shows what I consider the A and the B leg of what could be an A-B-C correction in gold. If gold turns down and touches 225,



it will have broken the recent rising trendline—in which case I would say the C leg of the correction was in force.

Note that GSA halted its rise just at the 50% level of its September-December decline so that the stocks are still lagging well behind the metal. For near-term indications, watch gold's ability (or inability) to hold above the 225 level.

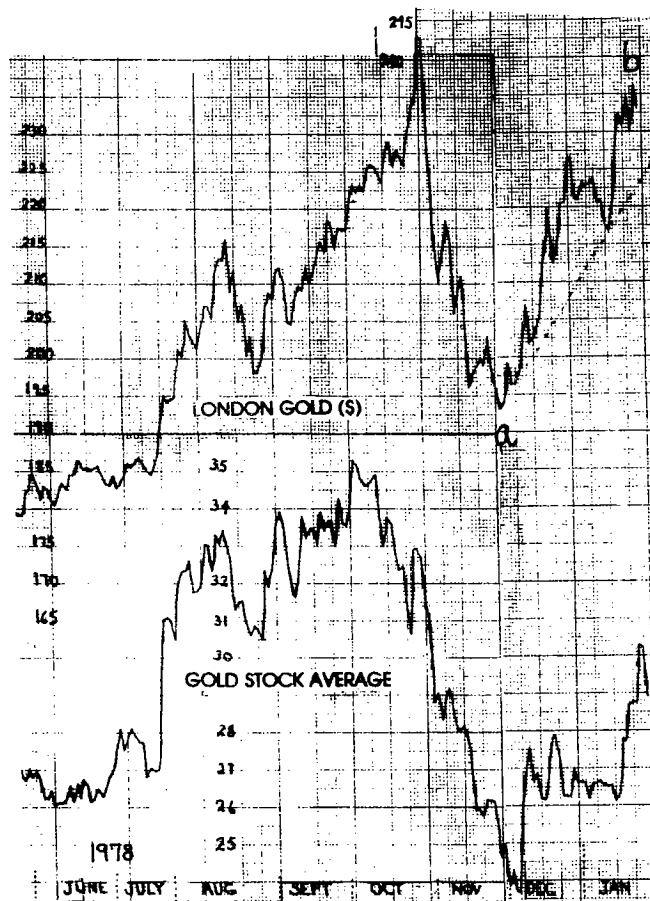
The P&F chart shown in the last Letter drew attention to the 228 breakout level. That level was achieved and gold promptly rallied to 236. Only the 243 high now stands as an upside barrier to gold. But with gold momentum (13 week rate of change down to 102 this week) I personally would not be willing to follow gold from here on the upside.

LATE NOTES: The stock market is chancy here and over-extended (over-bought). It therefore doesn't interest me here. Most interesting move for traders: buy middle to longer-term US bonds (or notes). Even more speculative: buy the June GNMA's (futures) on any pullback with a stop-loss at new lows for the contract. A fascinating, speculative and perhaps very profitable play for sophisticated speculators: short the June yen (futures) with a stop-loss at .535. I think the yen is preparing to take a big swoon.

For those who want tax-free Muni bond returns, I want to stress that many (most) individual Municipal bonds are illiquid. That means that when you want to sell them, it ain't easy, and you may be shocked at the bid and asked prices; that's why I prefer a Muni bond fund (no load). I believe we're seeing a bear market rally in bonds now, but it's a rally that could last a while. If you want to take a position in Muni's, I suggest you buy Fidelity Municipal Bond Fund here at around 9.42 with the stipulation that you sell it if it drops below 9.35. That should limit any risk if this bond rally peters out and at the same time provide tax-free income for those who need it (Fidelity 800-225-6190).

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For those who want the "safest" play in the money market (assuming a run-up in bonds) the middle issue Treasuries maturing around 1982 to 1984 might be best. Here, even if you're wrong on bonds, the worst you can do is sit for three to five years and collect a fat return. If the bonds rally strongly, you can sell 'em



out and take the profits. The following notes fill the bill: 8 3/8's of 1982, the 9 1/4's of 1982, 8's of 1983, the 7 1/4's of 1984.

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In the last Letter I showed a long-term chart of the Japanese yen and I stated that it looked as if the yen could almost crash against the dollar. One reason for gathering yen weakness: Japan lives on exports. And her exports of autos to the US are getting hit now—hard. Toyota and Datsun entered '79 burdened with a 10 month inventory of unsold autos, and it may be April before all the '78 models are cleared out (many at discounts). Japan has now lost its hold on the lowest end of the car scale—to US manufacturers. Reasons: the "cheap" dollar.

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There's a little book just out by Andrew Tobias called, "The Only Investment Guide You'll Ever Need." (Harcourt Brace, \$5.95). I urge all subscribers to buy this little gem. There's more common sense in these 160 pages than I've seen in many a month. This is an absolutely superb book to give to your wife or older kids, and you might even learn something about investments yourself—I know I did. Don't miss this book!

SKIRT lengths used to be used as a stock market indicator (higher hems point to higher prices, lower hems to lower prices). This year skirts are mixed, and the slit skirt is the big thing. I'm wondering what the message in that slit is—could it be "Look but don't touch!"

I'll be speaking at Howard Ruff's monster National Convention in Anaheim, Calif. Feb. 19-21. Speakers will include Presidential Candidate Philip Crane, Bob Bleiberg, Jim Blanchard, R. E. McMasters, Maury Kravitz, Hans Sensholz, Howard Ruff and many others. (For info. call 800-642-0204 in Calif., others call 800-227-0703.)

NEXT MAILING: February 14th